



Portfolio Manager Perspectives BlueBay Investment Grade Debt Update

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Alpha in Choppy Markets

As the market adjusts to the new volatility regime, finding pockets of value amid the Trump tweets, trade wars and tech wobbles is becoming ever more important.

Equity market turbulence has persisted over the Easter period, as tech stocks have wobbled with valuations of FAANG (Facebook, Apple, Amazon, Netflix, and Google) stocks under pressure as retail investors pulled funds amidst rising volatility. To provide some context, we are now witnessing the 3rd highest period of sustained S&P 500 volatility during the past decade, albeit on relatively anaemic volumes compared to previous episodes of market weakness. Most of the news flow in the past week has been more stock idiosyncratic – from worries related to the safety of driverless vehicles to Trump tweets targeting the business practices of Amazon. With underlying economic momentum remaining robust, we believe that volatility should subside in the weeks ahead. However, it seems increasingly clear that financial market volatility bottomed at the start of this year and that market participants are still struggling to adjust to the new normal and this means that market turbulence is something we are going to have to grow accustomed to.

Government bond yields have edged lower in the US and Europe over the past couple of weeks. Though with money market futures continuing to

discount two further Fed hikes for 2018, we have closed our short position with respect to duration and now favour a flat stance for the time being, even though we remain inclined to see materially higher yields in the medium-term. In contrast to the start of the year, when we viewed a short position in rates as an effective hedge to a portfolio positioned long in risk assets, it appears that correlations have shifted and we are wary that a further move lower in stocks could see yields also drop on a flight to quality. Although this is not our central view, we believe that there may be better entry points to return to a short duration stance in the weeks to come and we are keen to utilise market volatility as an opportunity in this context.

In the eurozone, we retain a sanguine view concerning political developments in Italy and sense growing frustration from those investors who have been shorting Italian government bonds (BTPs) looking for spreads to widen, with yields now 25bp lower than they were before the election one month ago. We continue to see no realistic path towards a referendum on Italian EU membership in the foreseeable future and with eurozone break-up risks continuing to diminish. It has been interesting to see how spreads across

the periphery have been narrowing since the start of the year, bucking the trend in risk assets elsewhere. In this context, we continue to view Greece as offering the most value, with spreads a multiple of three times those available in Portugal, by way of comparison. Proposals by France and the European Stability Mechanism (ESM) linking official sector debt forgiveness for Greece to ongoing reforms echo the impressions we formed on a recent trip to Brussels and we expect a deal to be concluded along these lines by the middle of the summer. With the Greek economy growing, a primary fiscal surplus and a supportive European backdrop, we expect further rating upgrades and tighter spreads in the coming months. Also, we would argue that taking a long position in a high-yielder such as Greece is far removed from much of the turbulence emanating from Trump tweets, trade war worries or tech stock volatility across the Atlantic.

Higher volatility has continued to make for a challenging environment for corporate credit spreads. Theoretical models would suggest that volatility is a factor in determining the fair value for spreads and with supply remaining heavy, new issues continue to re-price in the secondary market. We are inclined to believe that much of this move has now run its course and absent a deterioration in economic conditions (which we don't expect), credit quality should be well supported. In financials, AT1 debt appears attractive

and if underlying government yields are not rising, then we believe that it won't be too long before the hunger for yield returns.

Looking ahead, we expect market turbulence to abate, though it seems clear that volatility is not going to return to 2017 levels any time soon. Price action in risk assets may remain somewhat choppy but ultimately we believe that a robust economic backdrop and accommodative fiscal and monetary policies should reassure investors. We are keen to try to avoid consensual positions where we can, on the thought that where investors stop out of positions, this could make for challenging conditions. In this regard, it has been striking to get a sense from many macro hedge fund allocators that going short Italian BTPs has been a favoured trade of late. Generally speaking, these funds have had a poor track record investing in the eurozone periphery and it doesn't appear that this is about to change any time soon. More generally, we feel that notwithstanding equity market volatility, daily performance moves have been relatively modest and we remain comfortable with the risk we are running, looking for spreads to recover once calm returns. Our experience in Q1 encourages us that it is possible to take long risk exposure in the right parts of the fixed income market, without needing to fear that the FAANG's are going to be biting us any time soon. In a sense, it feels like time to buckle up, keep calm and put some carry on...

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